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[WSJ: Fast-Changing Federal Policies Shuffle Municipal-Bond Strategies]

Some sectors and localities could get an economic boost while other look more vulnerable in an uncertain market

Tariffs, deportations and potential cuts to the federal budget are pushing municipal-bond investors to reevaluate debt from school districts, hospitals, port operators and other issuers.

The shifting policy landscape means entities considered safe just a few months ago now look more vulnerable in an uncertain market, while some sectors and localities could get an economic boost. The changes have bond-portfolio managers sifting through their asset allocations for signs of trouble.

“On a daily basis, we are really hanging on to every” post on President Trump’s TruthSocial account, said Dan Close, head of municipals at Nuveen. “We are looking at everything that comes out of the administration to see how tariffs, regulations, immigration, the muni exemption is going to impact the overall market.”

Close said that Nuveen isn’t making significant changes to its portfolio until there is more clarity about federal policies. For now, his team is analyzing individual issuers to understand “what our exposure is [and] what the potential impact to that exposure is and then just being prepared.”

The political turbulence is making investing less predictable than usual across asset classes. U.S. stock indexes and Treasury yields have moved sharply as markets struggle to figure out how announced measures will hit the economy. In the multifaceted landscape of municipal bonds, the policy whirlwind touches nearly everything.

“Broad and rapid federal policy changes since January 20 have far-reaching credit implications for US public finance, nearly all of them credit negative,” Moody’s said in a recent report.

Overall, munis are still considered a very low-risk investment, appealing mainly to institutional investors and wealthy individuals looking to hedge their portfolios from rising volatility. But maintaining that safety has become more difficult given the new political winds.

In a sign of how the perception of risk evolved after Trump’s election, the yield-to-maturity in an S&P municipal-bonds index was nearly 0.2 percentage points lower than the 10-year Treasury yield last September. That means the asset class was perceived as safer than federal government debt. The spread turned positive as the election approached, peaking at 0.6 in early January. It stood at 0.2 Thursday, above the 12-month average, according to FactSet and Tradeweb data.

There are also stress signs within certain sectors that have become political hotspots. One concern is potential cost reductions in Medicaid under discussion in Congress as a way to secure budget room for federal tax cuts.

“Hospitals heavily reliant on Medicaid are at higher risk,” said Kevin Holloran, a director at Fitch Ratings. Potential federal budget cuts “could exacerbate these challenges, particularly in states with limited ability to offset reduced federal support.”

Total return for the S&P Municipal Bond Index was 0.25% this year as of March 13, while the hospital-specific gauge was a negative 0.08%, according to Nuveen.

Munis are particularly attractive to investors in the highest federal income tax brackets, because of their tax exemptions. Lawmakers are threatening to eliminate, or at least reduce, the incentives, in an added headwind for the overall municipal-bond market.

But even if the tax exemptions survive, a variety of other Trump policies are expected to hit munis.

Bonds issued by colleges are under investors’ microscope as the government threatens to pull funding for some institutions.

Big high-education names have enough revenue to keep honoring debt even without federal grants, Christopher Lanouette, managing director for CIBC Private Wealth, said. But the potential clash with Washington puts the whole sector under risk.

Lanouette said he is avoiding higher education as “you are seeing the Trump administration targeting certain colleges and universities.”

The Bloomberg US Municipal Index was up 0.06% this year as of March 13, while its education sector returned negative 0.08% over the same period, according to Nuveen.

“We are looking at things that look riskier now than when we bought them,” Jason Appleson, head of municipal bonds at PGIM Fixed Income, said. “You have to go sector by sector and look for areas of uncertainty.”

On the bright side, deregulation could alleviate near-term costs for utilities, Nuveen’s Close said.

To be sure, some portfolio managers don’t see the effects of Trump policies on munis as something particularly challenging. Paul Malloy, head of municipals at Vanguard, compared the elevated level of uncertainty with previous experiences such as the Covid pandemic.

“This is what we are here for; we are designed for this,” he said about dealing with uncertainty. “This is what our investors expect of us.”

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